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Nos. 323, 324.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1929.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

VS.

KANSAS CITY STRUCTURAL STEEL COMPANY.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

VS.

KANSAS CITY STRUCTURAL STEEL COMPANY.

BRIEF IN OPPOSITION TO PETITIONS FOR WRITS OF CERTIORARI.

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INDEX

Statement 1
Extracts from Stipulation of Facts 4
Propositions Involved 6
Brief and Argument 6
Argument on First Proposition 6
Argument on Second Proposition 7
Conclusion 16
Appendix—Opinion of Circuit Court of Appeals . . 17

CASES CITED

Atlantic Coast Realty Company vs. Commissioner of Internal Revenue, 11 B. T. A. 416, 418 13
Bank of Kentucky vs. Adams Express Company, 93 U. S. 174, 185 8
Eisner vs. Macomber, 252 U. S. 189 l. c. 206 7
23 C. J. 62 8

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Statement.

A judgment of the United States Board of Tax Appeals was promulgated April 30, 1928, affirming, by a divided vote, the action or judgment of the Commissioner of Internal Revenue in assessing an additional or deficiency income tax against the taxpayer for the

years 1918 and 1920. The tax was made up of several items, but this case involves only the portion based upon an alleged gain in inventory, comprising 5554 tons of unfabricated structural steel and steel plates set aside and kept on hand for emergency use. The cases as to both years were tried and submitted upon an agreed statement of all the facts, which will be found at page 20 of the printed record. As this Stipulation of Facts amounts to a special verdict with which the judgment must be in harmony, we conceive it to be our proper duty to present the facts quite fully. The petitioner has filed but one brief in both cases and we will do likewise.

The taxpayer was engaged in the business of fabricating and erecting, by contract, structural steel and steel plates for buildings, bridges, tanks and other structures. It fabricated and erected such material for each specific structure and contract and carried no finished product in stock. Material was ordered and procured, at the then market price, from the rolling mills for each specific structure and contract. However, a supply of material was kept on hand for emergency use only (under the practice herein set out) to insure the prompt and orderly execution of contracts, in view of delays incident to shipments from the mills and other exigencies affecting the availability for use, when needed, of the material theretofore ordered and purchased for the particular and specific jobs. The uniform and consistently observed plan and practice was that when, in such emergencies, material was so used from such supply, it was charged to the contract at its re-

placement cost, and upon receipt of the like material previously purchased for the particular job upon which such emergency material was used, was promptly replaced with material of a like kind and in a like quantity. The taxpayer was not a merchant, dealer or manufacturer and such material was not for sale and did not constitute a merchandising stock. On the contrary, it was a contractor for the delivery of the completed structure in place, involving and embracing all labor and material. The emergency material was very heavy and was kept in convenient piles of like kind. When such material was so used it was taken from the top of the pile (the Commisioner of Internal Revenue assumed it was taken from the bottom) and the replacement material was put on top of the pile from which the used material was taken or borrowed. The amount of such material on hand on December 31, 1916, was 5554 tons, which the taxpayer set aside and substantially maintained for such emergency use (and not otherwise) under the practice aforesaid, and carried it at its cost of $1.70 per hundredweight f. o. b. Pittsburgh, Pa., or, with freight added, at $2.136 per hundredweight f. o. b. Kansas City, Missouri. An alleged gain in inventory of this material forms the basis of the tax in controversy, which is in addition to the tax upon the taxpayer's income derived from the normal conduct of its contracting business.

The taxpayer contends that no income did (nor could prior to final liquidation) accrue from such emergency material as a basis for the imposition of the tax complained of, whereas the Commissioner of In-

ternal Revenue priced the same at the end of the year at the cost of a corresponding quantity of the most recent purchase of similar material and assessed a tax upon an assumed income based upon the difference between the value thereof, as of December 31, 1917, and December 31, 1919, respectively, and the higher value thereof, as of December 31, 1918, and December 31, 1920, respectively. This resulted in a fictitious increase of the taxpayer's taxable income, and the additional or deficiency tax which is in controversy.

The Stipulation of Facts upon which the case was tried provides:

> "The company is engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc. It fabricates material for specific structures or contracts and carries no finished product in stock. Material is ordered and procured from the mills for each specific structure or contract, except that a supply of material, as shown in Exhibit A, has been kept on hand for emergency use (from which material is borrowed and replaced) to insure the prompt and orderly execution of contracts in view of delay, etc., incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job. When such material is used it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity" (p. 21).

> "The company, at the end of the years 1916, 1917, 1918, 1919 and 1920, valued its said supply of 5554 tons at the cost price prevailing at the close of 1916, or $1.70 per hundredweight f. o. b. Pittsburgh" (p. 21).

"The Commissioner of Internal Revenue in pricing the inventory of the company has disregarded the said fixed quantity of 5554 tons assuming that the last purchases represented the entire inventory and using said last purchases as a basis for valuation" (p. 22).

BRIEF AND ARGUMENT.

The petitioner contends and bottoms his petitions for the writs upon the following:

(1) That the so-called "constant," "base" or "minimum" inventory principle is contended for by the taxpayer and was recognized and applied by the Circuit Court of Appeals;

(2) That the taxpayer is a manufacturer and not merely an ordinary building or construction contractor and that, therefore, the inventory statute and regulations applicable to dealers and manufacturers apply to the emergency material described in the Stipulation of Facts upon which the case was tried; and,

I.

As to the first proposition, that the Circuit Court of Appeals recognized and applied the so-called "constant," "base" or "minimum" inventory principle, it is only necessary to refer to the opinion wherein it is repeatedly asserted to the contrary.

In the majority opinion it is said (p. 52):

> "The Government urges that this is but another claim of the right to set up a 'minimum inventory' formerly but unsuccessfully claimed by retailers and dealers. If it is, then the appeal must fail; * * *."

In the minority opinion, it is said (pp. 58, 59):

> "I understand it is not intended to strike down the acts and regulations concerning resort to inventory for income tax assessments, but the court

discerns in the case of this taxpayer a peculiar situation amounting to an exception."

II.

As to the second proposition we submit that the taxpayer was a construction contractor and not a manufacturer or dealer; and the inventory statute and the departmental regulations made in pursuance thereof, were not applicable (under the agreed facts) to the 5554 tons of emergency material.

In the majority opinion of the Circuit Court of Appeals in this case, it is said (p. 53):

> "At the outset it should be remembered that a wide discretion is vested in the commissioner, and not in the courts; and if the business is one where there is any substantial evidence indicating the necessity for the use of inventories, his decision backed by majority opinion of the Board of Tax Appeals, should not be disturbed. On the other hand, if, under the agreed facts, a situation is presented where it is clear that the use of an inventory is not only not necessary, but as a matter of fact distorts rather than reflects income, then the appellant has a right to invoke the aid of the courts."

Under the principle announced in the case of *Eisner* v. *Macomber*, 252 U. S. 189, l. c. 206 (64 L. Ed. 521, l. c. 528), that:

> • • • "it becomes essential to distinguish between what is, and what is not, 'income' as the term is there used; and to apply the distinction as cases arise according to truth and substance without regard to form,"

t became the duty of the Circuit Court of Appeals to nalyze the Stipulation of Facts for the purpose of

determining, as a fact, whether or not the taxpayer derived any taxable income from the emergency material. This the Court did with great care and superb accuracy, treating the business activities of the taxpayer as they were, recognizing that income is the *sine qua non* of the tax and concluding that there was no income upon which the tax in controversy could be assessed.

It is obvious, from the opinion itself, that no rule of law was anounced by the Circuit Court of Appeals in conflict with any decision of this Court or of any other of the Courts of Appeals. What it did, and all it did, was, as stated, to analyze the true agreed facts and apply the settled law thereto, with the conclusion that inasmuch as there was no income, there could be no tax.

Moreover, it was the duty of the Circuit Court of Appeals to supplement (as this Court will do) the agreed facts with its judicial knowledge "of the general course of business and the usual methods of transacting it" (23 C. J. 62), and in connection therewith, to not close its "eyes to the well known course of business in the country" (*Bank of Kentucky* v. *Adams Express Company*, 93 U. S. 174, 185).

The Stipulation of Facts, so supplemented, establishes:

(1) The taxpayer was a building contractor and not a dealer or manufacturer; and its taxable income and deductible losses resulted from and were limited to its operations as such contractor.

(2) In making bids and contracts, the emergency material was not considered; and the cost, value, exist-

ence or non-existence thereof had no relation to the contract, the contract price or the taxpayer's profits or losses.

(3) Material was purchased and procured for each specific structure and contract prior to the use of any of the emergency material in such structure; and when emergency material was so "borrowed" and used upon a particular structure it was consistently and promptly replaced with material of like kind and quantity, normally (it may be assumed) utilizing for such replacement purpose the material so theretofore purchased and procured for such specific structure and contract, thus, in truth and substance, as distinguished from mere form, preserving the *status quo ante.*

(4) The agreed purpose or object of the use of such material was (and was so limited) to insure the prompt and orderly execution of contracts in view of delays in shipment and other exigencies affecting the availability for use when needed of the material *theretofore* purchased for the specific structure upon which such emergency material was used.

As a building contractor, the taxpayer's actual income accrued and was solely derived from the performance of its construction contracts, viz., the difference between the cost of such performance upon the one hand, and the money realized for such performanec upon the other. The cost of performing a contract includes and embraces labor, material, insurance, freight and sundry other usual and properly chargeable items of expense. Such cost, when compared with the contract price received, discloses the true income or loss. The aggregate

of its completed contracting operations for the year is determinative of its income, upon which it may be lawfully taxed. *The tax in controversy is in addition thereto.*

The following outline, conforming to the Stipulation of Facts and to the usual course of business, of which the Court will take judicial notice, discloses the methods and scope of the taxpayer's business and the relation of the emergency material thereto.

(a) An owner calls for bids from and submits plans and specifications of a proposed structure to those invited to bid. A typical instance is a bridge constructed for the State of Arizona across the Grand Canyon of the Colorado River or the steel frame of the Federal Reserve Bank Building in Kansas City, Missouri.

(b) Preliminary to submitting a bid, the taxpayer estimates the cost of performing the contract upon the basis of the then cost of all material (including steel), labor, insurance, freight, and all other properly chargeable items of expense, first securing from materialmen firm and binding commitments, based upon the then market price, for all the material to be used in the proposed structure, in absolute disregard of the emergency material and of its cost, value, existence or non-existence. These in the aggregate represent the cost of performing the contract. It then adds its contemplated profit to such aggregate cost; makes its bid accordingly; secures the contract containing penalty provisions for delay in completion beyond an agreed time limit and a bonus for prior completion; converts such prior commitments for all material into final purchases thereof;

and proceeds to the prompt, orderly and expeditious performance of the contract, at the conclusion of which it collects the contract price, plus extras and less deductions, resulting in a *then* profit or loss, as the case may be.

(c) Since the material was previously purchased and procured at the then market price for each specific structure and contract, it was immaterial whether the market price thereof thereafter increased or decreased, for, obviously, such change could not affect the cost of the material so already purchased and procured, or the taxpayer's profit or loss.

(d) It is likewise obvious that the cost, value, existence or non-existence of the emergency material had no relation to the contract or the contract price and was not considered in making the bid. Its agreed relation to and connection with the transaction was limited to the expeditious performance of the contract, or, as stated in the Stipulation of Facts, to "insure the prompt and orderly execution of contracts," in view of delays in shipments, et cetera, "affecting the availability for use, when needed, of the material so purchased and procured." Under these conditions (and not otherwise) it used such portion of the emergency material as the emergency warranted or required, charging the same to the contract at its replacement cost, but upon the condition and under the uniformly consistent plan and practice (constituting but a step in the completed transaction) that the portion of the emergency material so used would be promptly restored or replaced, normally utilizing for that purpose the

material so already purchased and procured for the particular job upon which the emergency material was used. The use of the emergency material was coupled with the concurring obligation to restore it in the manner specified; and no optional alternative existed to do otherwise without departing from the observed practice.

With these ultimate facts in mind, and viewing the transaction as a whole, the relation of the emergency material to the taxpayer's business and income may be tested upon every possible hypothesis with the result that it will be irresistibly demonstrated that such material was in no sense a source of income and contributed nothing to the taxpayer's profit, save only the incidental benefits resulting from the expeditious performance of its contracts, and that every financial aspect of the business was handled without regard to it. Let it be assumed that (1) there had been no such material on hand; (2) or, being on hand, no emergency arose for its use; (3) and that its cost, instead of being $1.70 per hundredweight, was the highest, or the lowest, figure to which the steel market went at any time; wherein would such situations have affected or changed the taxpayer's course of business or the earnings derived therefrom? In other words, if there had been no emergency material on hand at any time, the situation would have been identical, so far as earnings were concerned, and the only difference would have been the want or absence of "the prompt and orderly execution of contracts." Consequently, this material was merely a facility to obviate delays and minimize expense and

possible loss in performance, and had and served no other purpose and produced no other result.

If under any correct legal hypothesis applicable to manufacturers and dealers, an income resulting from a gain in inventory could be discovered as to them under as nearly an analogous state of facts as the nature of their buisness would warrant, the distinction will be apparent by the consideration of the normal relation which an inventory bears to their business, as compared to its non-relation to the taxpayer's business. A taxable gain in inventory, as distinguished from a non-taxable growth or increment in value of property, is naturally and normally limited to a situation where the goods or merchandise constitute the subject matter or stock in trade of the business of the taxpayer, and not, as here, where property is not a necessity but a mere convenient facility for expeditous operation, or where, as here, the business, and the profits thereof, are disconnected with and not dependent upon such property.

The limitation of the statute was recognized by the Board of Tax Appeals in the case of *Atlantic Coast Realty Company* v. *Commissioner of Internal Revenue*, 11 B. T. A. 416, 418, from which, for the general information of the Court, we quote, as follows:

> "The taxpayer with its affiliated corporation, was engaged in buying and selling land for profit. When it filed its consolidated return for 1918 it claimed for the first time that its income should be determined by the use of a so-called inventory of its lands at market value, and upon that basis it reported net income of $14,204.39 and paid a tax of $1,464.53. * * *

We are of opinion that the petitioner has no such right as it claims, that it may not determine its income by revaluing its lands from year to year, and therefore that there is no occasion for findings of fact as to market value of the parcels in question at the close of 1918.

Income is not ordinarily determined by the fluctuations in value of property upward or downward during the continuation of the same ownership. Increment is not added to, nor is a drop in value deducted from, earnings until it has been realized by a sale, loss or other cognizable disposition of the property. Section 203 is a departure from this and it must be limited to its apparent intendment as disclosed in its terms and if necessary in its history. It provides:

> 'That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.'

It was first enacted in the Revenue Act of 1918 and has remained unchanged in each of the later Acts of 1921, 1924 and 1926. In the report on the proposed 1918 Act made by the House Committee on Ways and Means, the Committee said:

> 'In many cases the only way that the net income can be determined is through the proper use of inventories. This is largely true in the case of manufacturing and merchandise concerns. The bill authorizes the Commissioner to require inventories whenever in his opinion the same is necessary in order clearly to reflect the income of the taxpayer.'

> The Senate inserted the words 'conforming as nearly as may be to the best accounting practice in the trade or business,' and thus the section was enacted.
>
> This carefully guarded language may not be construed as creating in all taxpayers the right to determine income by the use of inventory of property on hand. The use of inventories must be reasonably necessary to the determination of income. The basis of their use must be prescribed by the Commissioner, not arbitrarily, but in conformity to the best accounting practice in the trade or business and as most clearly reflecting income. The language indicates no intention to recognize in any trade a new method of determining income or a new limitation upon income, but only a recognition of the use of inventories in such trades or businesses, like 'manufacturing and merchandise concerns,' as had been found to require such accounting practice."

The petitioner makes the point, by way of argument, that since the taxpayer and the Commissioner of Internal Revenue participated in the practice of inventorying the occasional excess material (over and above the 5554 tons of emergency material) the taxpayer thereby conceded the propriety of the application of the inventory regulations to the emergency material. In answer to this point we cite the homely apothegm that, "two wrongs do not make a right." Such excess material should not have been inventoried at all; but, on the contrary, the cost thereof should have been figured into the contracts, thereby contributing to a profit or loss (as the case might be) in the performance of the contracts, determinative at the completion thereof. Such would have been proper accounting and reflective of true income. This was, erroneously, not done and, consequently, the Commissioner of Internal Revenue and the taxpayer substituted the inappropriate practice of inventorying such excess material and a tax was calculated and assessed upon the increase in the value

thereof. Such tax is not in controversy in this case. As pointed out, this method might very well have resulted in an erroneous tax, as the gain in inventory, in a particular year, might have been overcome by the loss resulting from the contracts themselves, completed in a subsequent year when the profits or losses accrued. However, since this excess material was not kept on hand for emergency use and was freed from the practice of borrowing and replacement (distinctions which we urgently emphasize), the application of the inventory regulations thereto may, or may not, have resulted in actual injustice. We submit that, under these circumstances (giving no heed to possible coercion or duress) this feature and aspect of the taxpayer's business has no bearing upon the question involved as to whether or not the inventory regulations should have been applied to the emergency material.

Conclusion.

As we have stated, the decision of the Circuit Court of Appeals is based upon the stipulated facts; and the opinion is such a clear analysis of such facts and so accurately demonstrates, akin to a mathematical certainty, that there was no income forming the subject of the tax, and that the inventory regulations are not applicable to the emergency material, we have taken the liberty of printing the same as an appendix hereto, believing, too, that the convenience of this Court will be thereby enhanced.

We respectfully submit the petitions for the writs should be denied.

Respectfully submitted,

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APPENDIX.

United States Circuit Court of Appeals. Eighth Circuit. May Term, A. D. 1929. *Kansas City Structural Steel Company, Appellant vs. Commissioner of Internal Revenue, Appellee. No.* 8358.

On Petition to Review Decision of the United States Board of Tax Appeals.

Mr. Armwell L. Cooper (Mr. Ellison A. Neel, Mr. Whitson Rogers and Mr. John P. Cooper were with him on the brief), for appellant.

Mr. Randolph C. Shaw, Special Assistant to Attorney General (Mrs. Mabel Walker Willebrandt, Assistant Attorney General, Mr. Sewall Key, Special Assistant to the Attorney General, Mr. C. M. Charest, General Counsel, Bureau of Internal Revenue, and Mr. Clark T. Brown, Special Attorney, Bureau of Internal Revenue, were with him on the brief), for appellee.

Before Lewis, Circuit Judge, and Woodrough and McDermott, District Judges.

McDermott, District Judge, delivered the opinion of the court.

This appeal brings on for review a decision by the Board of Tax Appeals, sustaining a deficiency assessment against the appellant in the sum of $7,656.74. The case was presented to the Board upon a stipulation of facts. The Board made findings of fact, which are substantially as stipulated. There is no record of any evidence being offered in addition to the stipulation, except that the opinion states:

"The evidence establishes clearly that some undeterminable part of the steel on hand in 1916 remained during the taxable years."

Whether there was other evidence of this fact is not material, for it is a natural inference deducible from the facts stipulated and found.

The question presented is whether, in arriving at the taxable income of the appellant, the Commissioner had a right to consider the inventory value of a stock of steel, set apart by the appellant as an "emergency" or "reserve" or "stand-by" stock.

It is stipulated that:

"The Company is engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc. It fabricates material for specific structures or contracts and carries no finished product in stock. Material is ordered and procured from the mills for each specific structure or contract, except that a supply of material as shown in Exhibit A has been kept on hand for emergency use (from which material is borrowed and replaced) to insure the prompt and orderly execution of contracts in view of delay, etc., incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job. When such material is used it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity."

Upon argument, it was stated and not denied, that the business of the taxpayer consisted, in large part at

least, of bidding for the steel work of buildings and bridges and other structures where steel is used; these bids are predicated upon firm offers procured from the mills for the steel involved, plus the cost of fabrication and a profit. If the bid was accepted, the materials were ordered for the job. This seems to be the only inference that can be drawn from the facts stipulated, to-wit, "It fabricates material for specific structures or contracts and carries no finished product in stock," and, "material is ordered and procured from the mills for each specific structure or contract." The taxpayer's business is closely akin to that of a building contractor, which, as far as steel is concerned, it is.

It is further stipulated that this emergency reserve consisted of 5554 tons of structural steel, being the amount on hand on December 31, 1916. Its cost was $1.70 per cwt. F. O. B. Pittsburgh. It is stipulated that this price of $1.70 "represented the highest normal market encountered since 1895." From that date on until December 31, 1921, this steel was treated as above stipulated. All materials of like dimensions were piled piece upon piece in perpendicular piles. This stock varied in size during the year, being both below and above the 5554 tons as material was used therefrom and replaced therein, the extreme limits from 1916 on, for any part of the year, being approximately 4000 and 11,000 tons. Except for the years 1917 and 1921, the reserve exceeded 5554 tons on December 31 of each year. These years are not in controversy and the shortage was inconsiderable. Whenever the reserve exceeded 5554 tons on December 31, the excess was valued at current prices, and a tax paid thereon.

In figuring up its taxable profit for the years 1918 to 1920 inclusive, the appellant treated this emergency steel as a part of its fixed equipment, and carried it at the 1916 cost price of $1.70 per cwt. The stipulation states:

"The Company, at the end of the years 1916, 1917, 1918, 1919 and 1920, valued its said supply of 5554 tons at the cost price prevailing at the close of 1916, or $1.70 per hundred weight F. O. B. Pittsburgh."

Since the reserve did not consist of the identical pieces in the pile on December 31, 1916, and which cost $1.70 per cwt. and since it was impossible to ascertain the cost of the steel actually in the pile, the Commissioner inventoried the entire stock at the market price of the steel most recently purchased, under the rule prescribed by Article 1582, Regulation 45, that the presumption is "the first in, the first out." Whether this presumption is a fair one in the face of the actual probability that workmen would take a girder off the top of a pile instead of the bottom, is challenged by the appellant, but need not be considered.

The result of the two methods of pricing the inventory was that the Government figured the income of the appellant to be $18,230.10 more than the appellant figured it. A deficiency assessment of $7656.74 was made; an appeal to the Board of Tax Appeals was unsuccessful; and the case is here on review.

Since the taxpayer figured this emergency steel as a part of its fixed equipment, no claim was filed for abatement under Sections 214 (a) (12), and 234 (a) (14) of the Revenue Act of 1918, for inventory losses

occurring when prices began to fall. On December 31, 1921, "after prices became normal" and when the price of the steel had dropped below the 1916 level ($1.50) the taxpayer acquiesced in the Government position, and the emergency reserve was priced by the taxpayer at its cost, or market, whichever was lower. It will thus be seen that the taxpayer had 5554 tons of $1.70 steel on hand on December 31, 1916; and 5554 tons of $1.50 steel of a like kind and in a like quantity on hand on December 31, 1921; and that no income had been enjoyed by the taxpayer through its maintenance of this reserve during the five years.

While no claim for abatement was made under the cited sections of the 1918 law, as recited in the stipulation, it does appear that before the Board of Tax Appeals the taxpayer asked credit for a loss in the inventory, due to the falling market in the year 1919. This claim is inconsistent with its present contention, and the record is not clear as to whether the taxpayer asserted this claim as a counter attack, after the Government had asserted the right to tax the paper profits on the same steel during the advancing prices. The Board of Tax Appeals upheld the Government's right to tax the profit on the advancing market, but denied the taxpayer the credit for losses on the falling market because they were not actual losses. The taxpayer has not appealed from that part of the order, but insists that if the Board denies a credit for losses because they are not actual, it ought not to tax income unless it is realized.

The good faith of the taxpayer is not questioned. The stipulation sets out facts indicative of good faith.

The reserve was set apart when prices were at the highest level since 1895; during the succeeding years its market value doubled, and yet the taxpayer did not liquidate it and take its profit; it kept it until prices were below the 1916 level, and it showed a loss; although the amount actually on hand, at the close of the year, was sometimes much more than 5554 tons, it accounted for the excess to the Government. It must be assumed that the reserve was in fact maintained, for the purpose as stipulated, and that it was reasonable in amount.

It will be seen at once that the underlying question is the propriety of including this reserve supply in an inventory taken as an aid to the ascertainment of income. Before dealing with that, it may be as well to consider one or two arguments made by the Government in support of its position. It is urged that in 1921, when prices had gone down, the appellant itself included the entire emergency reserve at 1921 prices, and that the taxpayer applies one rule when prices are high and another when prices are low. The Government makes the very sound argument that one of the prime requisites of any tax system is consistency; that when a taxpayer has adopted one system, it should be adhered to, in fair weather or in foul; and that no taxpayer should be permitted to play fast and loose with his Government. This very fair and sound rule does not apply however where the taxpayer changes his position at the Government's requirement; if the appellant is right in its contention, it cannot be denied relief because it, although still protesting, acquiesced

in the ruling, either because the drop in price had eliminated any substance to the disagreement, or because it became weary of the contest. It is also urged that the appellant, during these very years, included as a part of its income, the increase in value of the excess of the emergency steel over 5554 tons, and thereby attested the correctness of the Government's position. The conclusion does not follow. As to the excess, the appellant doubtless recognized that an emergency supply must bear a fair proportion to the requirements of the business; having determined that 5554 tons was an adequate reserve for a business that fabricated about 30,000 tons a year, it should account for any excess above that amount. Moreover, that the taxpayer may have paid more taxes than it should have, is not adequate reason for a disposition of this case. The Government urges that this is but another claim of the right to set up a "minimum inventory" formerly but unsuccessfully claimed by retailers and dealers. If it is, then the appeal must fail; but that is to assume the correctness of the real controversy, to which we now turn.

Inventories reflect what a man has, and not what he earns; they reflect capital, and not income; many times, in practice, they distort income. Many a merchant has paid an income tax predicated upon the cost or market of goods on his shelves, only to find that by the time the goods were sold, he had sustained a loss instead of a profit. The bankruptcy courts of the deflation period were flooded with claims of unpaid income taxes of the preceding years, a taxation on an in-

come never in fact realized,—a paper profit in an inventory which was turned into a loss in a few short months.

The use of inventories to reflect income is resorted to from necessity. There are a great many business institutions that must either take into account their inventories or not compute their income at all. It is a financial if not a practical impossibility to ascertain the cost and selling price of each spool of thread sold by a retailer, or each sack of flour made by a miller. If it could physically be done, the cost of the bookkeeping would be more than the gross receipts. Hence not only the propriety, but the necessity, of the use of inventories in certain lines of business.

The statute recognizes this, and the statutory power to use inventories is predicated upon necessity. Section 203 of the Revenue Act of 1918 provides:

"That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The regulation enacted in pursuance thereto provides (Art. 1581, Reg. 45):

"In order to reflect the net income correctly, inventories at the beginning and ending of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor."

Foulke on the Federal Income Tax (Sec. 642) says:

"Inventories are necessary in business affairs according to the exigencies of each particular case. The statute provides that inventories shall be used in income tax accounting whenever necessary in the opinion of the Commissioner to clearly determine income. The Commissioner thus has discretion to determine whether or not in fact inventories are necessary and which discretion is no doubt subject to review by the court, although no case appears to have yet arisen. Inventories are necessary in those cases where owing to the quantity of goods or commodities involved in the transaction it is not practicable to keep a separate account of each piece. An inventory is simply a lumping method of determining the gain or loss on the conversion of property in quantities where there is a fluctuation from year to year of the amount on hand, with a practical impossibility of separately itemizing the articles which are added or taken away."

It might correctly be said that the appellant is a fabricator, a constructor, and is not engaged in either the "production, purchase or sale of merchandise," except as incident to its work of construction, just as a builder of houses buys lumber and nails, and gets a lump sum for the finished product. But we prefer that the decision rest on broader grounds.

At the outset, it should be remembered that a wide discretion is vested in the Commissioner, and not in the Courts; and if the business is one where there is any substantial evidence indicating the necessity for the

use of inventories, his decision, backed by majority opinion of the Board of Tax Appeals, should not be disturbed. On the other hand, if, under the agreed facts, a situation is presented where it is clear that the use of an inventory is not only not necessary, but as a matter of fact distorts rather than reflects income, then the appellant has a right to invoke the aid of the courts.

In approaching the problem it should be remembered that all of acts of the Commissioner, all of the Treasury Regulations, all of the taxing statutes, draw their vitality from the Sixteenth Amendment to the Constitution, which gives to Congress the "power to lay and collect taxes on incomes." The Supreme Court said:

"Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised." *Eisner* v. *Macomber*, 252 U. S. 189.

See, to the same effect, *Taft* v. *Bowers*, decided by the Supreme Court of the United States, February 18, 1929, and not yet reported.

The taxing statutes and the regulations prescribe rules and regulations as aids in arriving at true income, and are not designed to create income. In all tax matters, as in most others, the form must give way to the substance. *Eisner* v. *Macomber, supra; Bowers* v. *Kerbaugh*, 271 U. S. 170; *Tucker* v. *Alexander*, 25 F. (2d) 425 (8 C. C. A.). The provisions of

the statute or regulations should not be extended, by implication, beyond the clear import of the language used. "Doubts are resolved against the Government." *Gould* v. *Gould,* 245 U. S. 151; *U. S.* v. *Merriam,* 263 U. S. 179; *Hellmich* v. *Hellman,* 18 F. (2d) 239 (8 C. C. A.). And this Court has said:

"This is, of course, the fundamental purpose of the law that the taxpayer should be taxed upon his actual income and that this should neither be diminished nor increased by any arbitrary or artificial method of computation. As the laws say, 'the true income must be clearly reflected,' and for this purpose the regular and long-standing methods of accounting employed by the taxpayer, established in due course and for no ulterior purpose, are to be indulged.

* * * But, if the books are kept, as the record shows they are, to show the exact state of the income upon completed contracts in each year, it is not perceived how greater difficulty can arise in the case of engineers than in that of building and construction work generally. Furthermore, the Government does not seek to secure a return upon income which is not accurate in fact and which casts an unjust burden upon the taxpayer." *In re Harrington,* 1 F. (2d) 749 (8 C. C. A.).

Income has been authoritatively defined as "the gain derived from capital, from labor, or from both combined," and in referring to that definition the Supreme Court has said:

"Brief as it is, it indicates the characteristic and distinguishing attribute of income, essential for a

correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived—*'derived—from—capital'—'the gain—derived—from—capital,'* etc. Here we have the essential matters; *not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *'derived,'* that is, *received or drawn by* the recipient (the taxpayer) for his separate use, benefit, and disposal; *that* is income derived from property. Nothing else answers the description." (Italics by the court.) *Eisner* v. *Macomber*, 252 U. S. 189.

The regulations cannot be broader than the statute. The statute authorizes the use of inventories, when, "in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer * * *." While no case has apparently decided the question, it is undoubtedly true that the opinion of the Commissioner must be predicated upon facts reasonably justifying it; it may not be arbitrary. Foulke on The Federal Income Tax, Sec. 642.

Is there any basis for determining that an inventory of this emergency steel is necessary in arriving at appellant's income, prior to the time when it is liquidated? It is stipulated that the appellant "carries no

finished product in stock''; that is, unlike a retailer or wholesaler, or a miller, it is not a dealer. ''It fabricates material for specific structures or contracts''; that is, it gets a contract first, and then does the work. Except for the supply in question, and the excess inventory on which taxes are paid, ''material is ordered and procured from the mills for each specific structure or contract''; that is, it buys on the market and at the market for each job. Sometimes, when work is progressing, the material ordered is delayed in shipment or transit; rather than delay the job, then and then only—''for emergency use (from which material is borrowed and replaced)'' —the reserve steel in question is resorted to. When it is so used, ''it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like ~~quality~~ quantity;''—presumably, as stated in argument, from the delayed car.

We have then this situation: the appellant is fabricating steel at Kansas City, some distance from steel mills; realizing the chance of delayed shipments, and in order to be able to compete in prompt execution of its contracts with other plants located near the mills, it carries a ''stand-by'' stock, replacing each girder used therefrom by the one ordered. There is in fact no profit at all realized from this emergency supply, other than the reputation of promptly doing the work. The profit of each job is exactly the same as if it had no such reserve. The profit is the same as if it borrowed the steel from a neighbor instead of from this pile. In fact, it might very well be that half this reserve steel would go into a bridge that showed a

loss on the entire contract. The pile is the same on December 31, 1916, as it is on similar days in each succeeding year, except for the two years noted and not here involved. As long as it remains intact, there is no income from it, no matter what the market fluctuations are. When, if ever, it is liquidated, there will then be a profit or loss, but until then it is like its derricks and its cranes and its buildings; it is useful in the business, but until liquidated, can show only paper profits which are neither realized nor taxable.

Upon argument it was urged that when the taxpayer took $1.70 steel out of the pile and put it in a $4.00 contract, he made a profit; and whether he reinvested that profit in other steel that went into the pile, is immaterial. This overlooks the stipulated facts. The taxpayer's contract was figured on $4.00 steel which he ordered from the factory; if a $1.70 girder was "borrowed" from the pile today, put into a bridge, and "replaced" tomorrow in "kind" with a $4.00 girder, there is no profit as long as he keeps the $4.00 girder for emergency use. In the briefs, it is argued that the appellant is like a merchant, who constantly replenishes his stock, always striving to keep a stock on hand to meet the demands of his trade. That but begs the question. In the first place, inventories are "necessary" for the multitudinous transactions of merchants, who buy first and sell afterward; they are not necessary for those who keep no finished stock, who sell no goods, and who always contract first and buy afterward. Moreover, merchants keep no stand-by stock for years, promptly replacing in kind each item borrowed therefrom.

Taking the whole business of the taxpayer, as stipulated, and bearing in mind the admonition that the substance and not the form controls, we cannot escape the conclusion that, as a matter of fact, the existence or absence of this emergency supply doesn't add a dollar to the profit the taxpayer made on any contract he has ever executed; under the facts, it cannot affect his income, except as a good reputation helps him to other contracts, upon which he will pay a tax. When he abandons or cuts down the emergency pile, then he must account for his profit over the 1916 price of $1.70; but, like his cranes and derricks, until he does dispose of them, no taxable income accrues from the mere ownership. The facts in this case show that on December 31, 1916, this steel cost the taxpayer $1.70 per cwt. All during the years he kept it up and used it as an emergency reserve; in December 1921, it took it into account for tax purposes,—a theoretical liquidation. On that date, it was worth $1.50 per cwt., twenty cents less than it paid for it in 1916. Yet, by virtue of its ownership, the Government has assessed a tax predicated on a profit of $18,000.00. True, income must be on an annual basis, and losses of this year may not offset profits of last. But here there was no actual profit in any year, and no actual profit when liquidated. An Iowa farmer who owned $150.00 an acre land in 1916, and who sold it in 1924 for $150.00 an acre, cannot be taxed because in 1918 or 1919 it had a market value of $300.00 an acre. This analogy, it is true, overlooks the specific individuality of two identical girders which may be interchanged one day

with the next—"borrowed" and "replaced." But that is of the form rather than of the substance. The appellant derived no income during the years from the ownership of this emergency supply; it was a part of its equipment for doing business; its business was such that it was not necessary to include it in the inventory to arrive at actual income; to so consider it, distorts rather than reflects, the true income of the taxpayer.

This decision is necessarily confined to the facts of this particular business. If the appellant were a merchant or a manufacturer, where inventories were necessary to arrive at income, it must take into account all of its stock, and cannot set apart a "minimum" inventory. If the appellant, a builder, used this emergency supply for tucking away profits actually made, it could not escape. If there was bad faith, or an excessive reserve, it would be otherwise. If it liquidated the pile and took its profit, it must pay. But these are not the stipulated facts. The stipulated facts show a builder, who keeps a supply of building materials against an emergency; it is reasonable in amount; it does not liquidate it on a high market and take its profit; it held it for years as a part of its fixed equipment; it never made a dollar out of it except as it enabled it to secure other contracts on the profits of which it paid a tax; its existence produced no income and there should be no tax.

The order appealed from in this case, and in No. 8359, stipulated to abide this case, are reversed.

Filed May 14, 1929.